This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 03 ANKARA 002077

SIPDIS

SENSITIVE

STATE FOR E, EB/IFD, AND EUR/SE
TREASURY FOR OASIA - JLEICHTER AND MMILLS
NSC FOR MBRYZA AND TMCKIBBEN

E.O. 12958: N/A
TAGS: EFIN ECON TU
SUBJECT: MARKET CORRECTION DESPITE CONTINUED POSITIVE MACRO NUMBERS

REF: ANKARA 1926

¶1. (Sbu) Summary: On April 8, Turkish financial markets experienced one of the few significant corrections in recent months, with interest rates blipping back up over 22 percent, the lira falling to TL 1.334 million to the dollar and the stock market falling 3.10 percent. A confluence of negative factors are blamed for the correction: an increase in Central Bank TL auctions, negative comments on Turkey's EU accession bid by the French Foreign Minister, anti-Annan Plan announcements by both Greek and Turkish Cypriot leaders, the increased fighting in Iraq, and the upcoming Easter weekend for Western investors. The announcement of better-than-expected numbers for the first quarter primary surplus and February Industrial Production failed to buoy the market. The correction comes after a sustained period of gradually improving markets, including successful moves by the Turkish Treasury in March to issue some slightly longer-dated lira-denominated bonds. End Summary.

Markets Dip April 8:

¶2. (U) Equity, fixed income and foreign exchange markets all fell sharply April 8. The IMKB 100 stock exchange index fell 3.10 percent on the day to 19,419, perhaps because the stock market had benefited the most from the recent spate of market bullishness: analysts, bankers and hedge fund managers have all told econoffs that the best "Turkey play" is equities, since there is more upside than in fixed income assets, which are constrained from falling too far by inflation, and bank funding costs. Government securities prices and the lira exchange rate also fell sharply (see below).

Government Debt Market Developments:

¶3. (Sbu) Interest rates on the benchmark bond rose back over 22 percent to 22.40 at the close April 8, with an unusually high trading volume of TL 2.2 Quadrillion on the benchmark bond. Interest rates had slowly trended lower in recent weeks, with the benchmark getting below 23 percent only on March 19--following the Central Bank's 200 basis point rate cut March 17. The benchmark gradually inched downwards, getting below 22 percent March 30, and hitting a low of 21.41 April 2, before coming back over 22 percent on April 8. Despite the Central Bank rate cut, both Istanbul analysts and Treasury officials say rates could not fall further, especially short-term rates, because bank funding costs (which key off of the Central Bank's overnight rate, currently 24.60 percent on a compound basis) are still higher than government securities rates. The gently downward sloping (i.e. inverted) yield curve means that banks are betting on further rate cuts in the future. Without further cuts, banks would have a "negative carry" on their government securities portfolios. These contacts explain that banks--the dominant players in the government securities market--lack access to medium- or long-term funding, and even their portfolios of bonds with maturities of 12 to 18 months represent a maturity mismatch: they are funding medium-term government bonds with short-term deposits.

¶4. (Sbu) Both Treasury domestic debt manager Volkan Taskin, and Istanbul market analysts say that it is for this reason--the absence of domestic buyers of longer-dated paper due to buyers' short-term funding--rather than a Treasury bet on lower interest rates, that has prevented more issuance of long-dated TL-denominated paper to the market. For this reason the average maturity of TL-denominated debt outstanding in the market--not including FX-linked paper or

TL paper placed with non-market investors such as the state banks and other public institutions--stayed more or less constant in late 2003 and early 2004 at about 12 months. Since the beginning of March, however, Treasury has issued several bonds with maturities exceeding twelve months, such as the issuance of an additional $1.54 billion of TL benchmark bonds, maturing August 24, 2005 on April 6.

¶5. (Sbu) Taskin, some Istanbul bankers, and Central Bank markets department head Akil Ozcay separately said Treasury did a good job of exploiting favorable market conditions during the first quarter of 2004 to front-load debt issuance for the 2004 borrowing program. During the first three months of 2004, Treasury's rollover rate has been 94 percent, well above the targeted average for 2004 of 87 percent. Treasury's heavy issuance early on will place its domestic TL debt managers in a stronger position for the remainder of the year, only needing to rollover an estimated 84 percent of its debt, on average. Repeating an ongoing concern of Central Bank officials, however, Ozcay said Treasury's focus on lowering its rollover rate means the Central Bank has to do more to mop up excess liquidity in the market for monetary policy reasons.

Lira Falls out of Trading Range...

¶6. (Sbu) In a departure from recent years' exchange rate volatility, for the past few months the lira has been trading in a relatively narrow range, typically just above 1.3 million lira to the dollar. The stability of the lira has been maintained, in part by the Central Bank's policy of fine-tuning its auctions of foreign exchange. The Central Bank fine-tuning has depended on the level of TL liquidity, arising in part from inflows of foreign portfolio investors' money and partly from continued reverse currency substitution (i.e. people keeping more of their holdings in TL than in the past). Though the Central Bank denies that it is trying to influence the level of the lira, it has claimed it is merely trying to dampen exchange rate volatility. Privately, Ozcay explained that the Central Bank also adjusts its foreign exchange auction as a monetary policy tool, to sterilize inflows of foreign portfolio investment that would otherwise work against the Bank's monetary tightening.

¶7. (Sbu) Having increased its FX purchase auctions (TL sales) from $80 million to $100 million a few weeks ago, the Central Bank upped them to $140 million late in the day on April 7. Earlier the same day, Ozcay told econoffs the Central Bank was considering intervening, but later settled on the milder action of increasing the auctions. In retrospect, the Central Bank may have gone too far. The following day, helped by French Foreign Minister Michel Barnier's negative statements on Turkey's EU accession prospects, calls by both Greek Cypriot leader Pappadopoulos and Turkish Cypriot leader Denktash for voters to oppose the Annan plan, and increased fighting in Iraq, the lira tumbled from 1.314 to the dollar and 1.603 to the Euro at the close on the 7th to 1.335 and 1.615 at the close on the 8th. The approach of the Easter weekend for Western investors may have also played a role, as some foreign investors did not want to hold Turkish exposure over the long weekend (long in Western Europe and America, that is). Economist Baturalp Candemir of HC Istanbul privately grumbled to econoff that the main culprit in the sell-off was the Central Bank, since the markets understood that Barnier's comments mainly reflected domestic political posturing and that Denktas' and Pappadopoulos' statements were expected. Other analysts, such as Deutsche Bank's Tevfik Aksoy, attributed the sell-off to multiple factors, but with the Central Bank's action the single most important. On the other hand, Central Bank officials privately downplayed the impact of their auctions. putting more weight on the geopolitical developments. Candemir said many of his firm's clients had lost money on April 8, and would not quickly return to Turkish markets. Comment: Given the almost uninterrupted bull market in recent months, the slap on "hot money" investors' wrists is probably healthy. End Comment.

...Despite Favorable Macroeconomic Data:

¶8. (Sbu) Ironically, on the day of the sell-off additional positive macroeconomic numbers were released, building on some favorable news in recent weeks. In the afternoon of April 8, Finance Minister Unakitan announced a better-than-expected primary surplus of TL 7.21 Quadrillion ($5.52 billion) for the first quarter of 2004. This means that not only is the GOT's fiscal situation being helped by

lower-than-expected interest costs but that the broader fiscal situation--excluding interest payments--did well in the first quarter. On the same day, the State Statistical Institute announced better-than-expected industrial production numbers for February: a 15.6 percent rise over February 2003. Though the number was encouraging, coming in well above the consensus estimate of 10 percent, economists point out that the increase industrial production was boosted by the base effect arising from very weak production early in ¶2003. Economists therefore remain of mixed views on how optimisitic to be about full-year 2004 GNP growth.

Markets Ease Back up on April 9:

¶9. (Sbu) On April 9, helped by the good news on fundamentals, the markets recovered, but only very slightly. At the close, the lira had come back a hair to 1.332 to the dollar and 1.612 to the Euro, while the benchmark interest rate eased to 22.06 and the IMKB 100 stock market index was up 0.44 percent to 19.505.
EDELMAN